In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 313

WARREN BURNETT AND EMMA BURNETT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner,[1] an attorney specializing in personal injury and workmen's compensation litigation on a contingent fee basis, made advances to selected clients to provide for their living expenses while he handled their claims. These advances were made with the understanding that repayment would occur when and to the extent that petitioner was successful in effecting a recovery on the client's claim. From 1957 to 1961, such advances were made to 450 of the approximately 2,200 persons petitioner represented. Total advances

[1] Mrs. Burnett is a party because the income here in question was community property under Texas law. Mr. Burnett will be referred to as petitioner.

226-793—66

for each year ranged between $10,000 and $170,000. At the close of 1961 petitioner had recovered 96% of the 1957 advances, approximately 85% of the 1958 and 1959 advances, 75% of the 1960 advances, and 34% of the 1961 advances, and only $4,417 of advances had become totally worthless. This high rate of return was attributable to the fact that petitioner made advances only to those clients whose claims would in all probability be successfully concluded. (Pet. A1–A3, A8).

On his 1961 federal income tax return petitioner, a cash basis taxpayer, claimed a deduction for $50,417.18 described as "Advances to Clients Net of Collection on Settlement." With minor adjustments, this figure represented petitioner's advances to clients during the year ($169,676.20) less repayments by clients of prior advances ($112,923.14) (Pet. A3). The Commissioner of Internal Revenue disallowed the deduction for advances to clients. The Tax Court sustained the Commissioner, and the court of appeals affirmed. (Pet. A3, A4, A11.)

The decision below is correct, and there is no conflict of decisions or any other basis for further review by this Court.

The crux of this case is whether petitioner's advances of funds to his clients for living expenses are ordinary and necessary business expenses—in which case he is entitled to a deduction under 1954 Code § 162(a)—or whether such advances constitute loans or losses—in which case he is not entitled to a deduction unless or until the advance becomes worthless—1954 Code §§ 165 and 166. Two courts below have

held that since the petitioner's testimony and the records of actual repayments show that the advances were virtually certain to be repaid (Pet. A4, A7), they did not constitute deductible expenses.

The principal thrust of petitioner's argument is that the advances do not qualify as loans or debts in the technical sense because his clients were not under an unconditional obligation to repay (Pet. 7–9).[2] Properly rejecting this formalistic approach, the court of appeals pointed out that the question of deductibility as an ordinary and necessary business expense under Section 162(a) must be determined by examining all of the circumstances and conditions under which the outlay was made, and that the omission of an unconditional obligation to repay is only one factor to be considered (Pet. A7, A8). Significantly, the court of appeals observed, there is nothing in this record to indicate that petitioner's high rate of recovery would have increased if his clients had assumed personal liability for repayment (Pet. A9). The advances in issue, having virtually all of the characteristics of loans, cannot be regarded as amounts used up—*i.e.*, as expenses paid—at the time the advances were made.

Petitioner argues that if the decision below is permitted to stand, he may never receive a deduction for advances which are not repaid (Pet. 7–9). In making this argument petitioner ignores the fact that during

[2] Under this approach a financial institution might well claim a current deduction in the not unusual situation where it makes a loan secured by real estate or other property and the borrower is not personally liable for repayment.

the taxable year involved, he claimed and was allowed a deduction for "loss * * * on advances to clients in connection with cases closed in the taxable year" (R. 156).[3] Thus, it is apparent that only the timing of the deduction is involved here, not its forefeiture, and that the "harsh tax consequences" foreseen by taxpayer (Pet. 11) are imaginary.

The result below is consistent with all of the previous cases involving the deductibility of attorneys' advances to clients.[4] Nor does *RCA Communications, Inc.* v. *United States*, 277 F. 2d 164 (Ct. Cl.), conflict with the instant decision. In that case RCA was permitted to deduct dollar payments made to a New York florist in connection with a flowers-by-wire service originating in Berlin. The Commissioner argued for disallowance primarily on the theory that the service conducted by the corporation was illegal and that allowance of tax benefits would frustrate sharply defined public policy (p. 166). Deciding the primary issue for taxpayer, the Court of Claims also rejected the additional argument that the deduction should be denied because RCA anticipated reimbursement from the senders of the flowers (p. 167). At most, that case held that ordinary and necessary expenditures by

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[3] "R" references are to the printed record before the court of appeals.

[4] See *Hearn* v. *Commissioner*, 309 F. 2d 431 (C.A. 9), certiorari denied, 373 U.S. 909 (attorney denied deductions for advances to clients for litigation costs); *Monek* v. *Commissioner*, decided February 25, 1966 (P-H Memo T.C., par. 66,110) (attorney denied deductions for advance of living expenses to clients); *Cochrane* v. *Commissioner*, 23 B.T.A. 202 (attorney had absolute right to reimbursement).

a taxpayer in the form of payments to its suppliers for services or merchandise are not made non-deductible merely because the taxpayer expects to pass the cost on to his customer. That case is clearly distinguishable from the instant one where petitioner has advanced or loaned funds to a client and expects the person to whom the funds were advanced to repay the loan.

The petition for certiorari should be denied.

Respectfully submitted.

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